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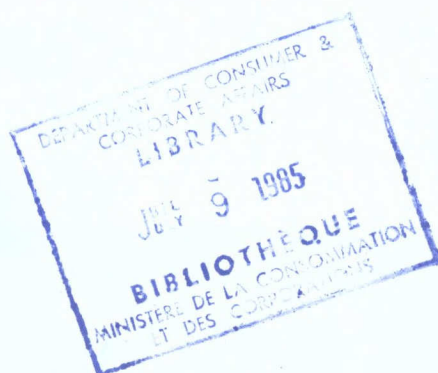
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**TAX REBATE DISCOUNTING:**

**A DISCUSSION PAPER**

**June, 1985**



**(aussi disponible en français)**



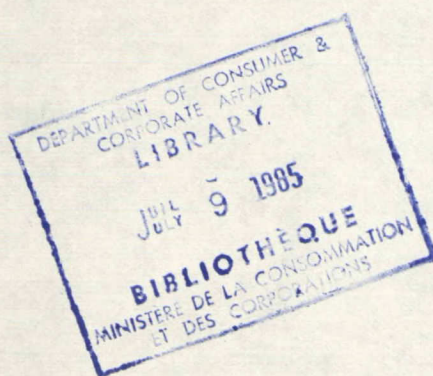
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#### **Outline**

	<b>Page</b>
<b>A. Introduction</b>	1
<b>B. Historical Development</b>	1
<b>C. Current System</b>	2
1. Description	
2. Impacts	
<b>D. Related Considerations</b>	3
1. Tax Return Processing	
2. Tax Credits	
3. Withholding Tax	
<b>E. Options</b>	4
1. Repeal Statute and Allow Criminal Code to Apply	
2. Prohibit Discounting	
a) Completely	
b) Selectively	
3. Lower the Cost	
a) Overall Reduction	
b) Graduated Reduction	
c) Selective Reduction	
d) Price Ceiling	
4. Encourage Inexpensive Alternatives	
5. Combinations	
<b>F. Limitations on Federal Action</b>	6
<b>G. Recapitulation</b>	6

#### **Appendix**

- Chart 1: Discounting Market, 1979-1984
- Chart 2: Discounting Market, 1984, by Reported 1983 Income
- Chart 3: Proportion of Population that Discounted in 1984,  
by Income Levels
- Chart 4: Distribution of Discounted Refund Values, 1984.
- Chart 5: Selected Data

## **TAX REBATE DISCOUNTING:**

### **A DISCUSSION PAPER**

#### **A. Introduction**

Every year, three out of four Canadian taxpayers have income tax overpayments refunded to them. Over the last several years, more and more Canadians have chosen not to wait for their tax returns to be processed by Revenue Canada, and have turned instead to tax rebate discounters. In exchange for the right to a taxpayer's entire anticipated refund, a discounter will prepare the tax return and pay the taxpayer, usually within two days, a percentage of the refund's value.

In this way, people can obtain cash almost immediately. They pay a price for this privilege, though - usually 15% of the refunds to which they are entitled. In most cases, those who pay that 15% are among Canada's lowest income-earners. In many cases, that 15% is taken from tax credits, particularly Child Tax Credits, intended to assist low-income families. Is tax rebate discounting still a socially acceptable business practice? If so, how can any negative effects be reduced? If not, how can it be curtailed without unwanted side effects? This paper seeks to describe briefly some approaches to these questions.

#### **B. Historical Development**

Although tax refunds have been legally discounted for many years, the practice did not begin to attract much public attention until the 1970's. At that time, particularly in the Western provinces, discounting "offices" began to open, and discounters would charge 40%, 50%, or even 60% of a refund's value for their services. In response, legislation to regulate these discount rates was enacted in some provinces. For example, in 1977, Manitoba restricted the amount that could be charged for discounting provincial refunds to 5%. In 1978, primarily at the request of certain provincial governments, the federal Tax Rebate Discounting Act was proclaimed, imposing a 15% limit on the discount rate. Ontario and Newfoundland subsequently repealed their legislation, while Manitoba and Saskatchewan amended theirs to be consistent with the new federal law. Provincial legislation regulating discounting also remains in force in British Columbia, Alberta, and Nova Scotia, while discounting provincial tax refunds is prohibited in Québec.

In 1979, the first year of the Act's operation, about 7,000 discounting transactions were officially reported. That number has at least doubled in each ensuing year until, in 1984, about 385,000 transactions were reported. The number of discounting offices has also increased dramatically, from a few scattered offices in 1979 to more than 1000 offices in all parts of Canada, in 1984. These offices discounted refunds worth about 275 million dollars in that year, keeping about 41 million dollars as their share.

## C. Current System

### 1. Description

Current federal legislation requires that discounters pay their clients at least 85% of the value of the refunds being acquired. Any tax return preparation charge must be included in the 15% portion which the discounter is entitled to keep. In addition, a detailed written statement of each transaction (a Schedule I) must be provided to the customer and to the government. When the discounter eventually receives the refund cheque, the customer must be advised in writing (through a Schedule II) of its value, and must be paid any amount by which the actual refund exceeds the original estimate.

In customary practice, a customer takes his or her taxation information slips (T-4's, TFA-1's, etc.) to the office of the discounter, who usually prepares the tax return, and has the customer sign a purchase and sale agreement and an authorization for release of information. Normally within two days, the discounter determines through Revenue Canada whether the customer owes any taxes from previous years. The customer then returns to the office and receives the discounter's cheque for at least 85% of the estimated refund. The customer signs the Schedule I form and a Power of Attorney or similar document, which acknowledges the discounter's authority to cash the customer's refund cheque after it is received from Revenue Canada. The discounter sends the Schedule I and the completed tax return, on which the discounter's address now appears instead of the customer's address, to Revenue Canada. After the tax return is assessed, a refund cheque payable to the customer is sent to the address of the discounter, who cashes the cheque, calculates any amount by which the actual refund exceeds the estimate, and sends a completed Schedule II and a cheque in the amount of the excess to the customer.

### 2. Impacts

#### a. Low Income Canadians

In 1984, almost 2 out of 3 persons who discounted reported a 1983 income of less than \$8,000, and nearly 1 out of 3 reported an income of less than \$2,000. It can therefore be concluded that low-income Canadians form the bulk of the clientele of discounters. Furthermore, the proportion of Canadian taxfilers who discounted was much higher at lower income levels; for example, about 1 in 16 Canadians with incomes below \$2,000 discounted, while the average for all income levels was about 1 in 40.

#### b. Child Tax Credit Claimants

In 1984, the portion of tax refunds retained by discounters amounted to over 41 million dollars. It is estimated that 15 to 20 million dollars of that amount was made up of Child Tax Credit payments. Of those Canadians who discounted their refunds, nearly half (43.6%) claimed a Child Tax Credit. Again, the proportion of Child Tax Credit claimants who discounted was much higher than average at lower income levels; among single mothers with an income below \$2,000, 1 in 5 Child Tax Credit claimants discounted.

c. Discounters

In 1984, over half of all discounting transactions were conducted by branch offices or franchisees of a single company, H & R Block (Canada) Ltd., a wholly-owned subsidiary of an American firm. About one-third was handled by Beneficial Finance Canada, Inc. (Ben Tax), a subsidiary of another American corporation, Beneficial Corp. The former entered the market in 1983, and quickly grew from 29 discounting offices to over 800 in 1985. The latter began operating in 1979, subsequent to federal and provincial governments urging financial corporations to consider discounting. About one-sixth of the discounting market is handled by smaller independent companies, many of whom conduct only 5 or 10 transactions in a year. Most discounting outlets are small store-front offices or shopping mall kiosks, employing 3 or fewer people, and operating only during the busy season from mid-January to the end of April.

**D. Related Considerations**

**1. Tax Return Processing**

Tax returns must be completed, and mailed to Revenue Canada, where they undergo clerical examinations, data conversion, and computer processing. The data thus produced are sent to the Department of Supply and Services, which prints and mails the refund cheques. Every year, about 15 million tax returns are handled in this way, mostly during the early part of the year. Special procedures are in place for simple returns. Thus, in 1985, the "Tax Guide" indicated that some simple and accurate returns could be processed in four weeks, and that full-scale computer processing would begin in mid-March. During the first quarter of 1985, nearly 3 million refunds were mailed by Revenue Canada, compared to 2 million in the corresponding period in 1984.

**2. Tax Credits**

In the last several years, the value of income tax refunds themselves, particularly among low-income taxfilers, has risen sharply. At least part of the reason is the increased use of the taxation system as a means for the delivery of lump-sum, income-related, social assistance payments. Various types of provincial support payments, and the federal Child Tax Credit, are delivered via tax refund cheques. The Child Tax Credit, introduced in 1979, was worth up to \$367 per child in 1984. Its value will increase to \$524 by 1989, and will be indexed in subsequent years to the annual increase in the cost of living in excess of 3 percentage points. It has particular significance for low-income mothers. In 1985, for example, a mother of 5 children with no other source of income was entitled to a tax refund of over \$1,800 in Child Tax Credits alone. Furthermore, she can be ready to file her tax return as early as the third week of January, when the TFA-1 forms are sent out by the Department of National Health and Welfare, but before Revenue Canada's processes are ready to handle it. For these reasons, perhaps, the proportion of low-income, single, female Child Tax Credit claimants who discounted was 4 times as great in 1984 as in 1983, and 10 times as great as the overall average. However, if the frequency of their payment were increased, as suggested in April, 1985 by the Standing Committee on Health, Welfare, and Social Affairs, the discounting of Child Tax Credits would be dramatically reduced.

### **3. Payroll Deductions**

The structure of Canada's "withholding tax" system permits greater overpayments among seasonal workers and other workers who are unemployed for part of the year. Furthermore, many deductions and credits which may be claimed when filing a tax return are not claimed when source deductions are calculated.

#### **E. Options**

Representations have been made through the media, in the House of Commons, by various social welfare organizations, and by members of the general public, that the tax rebate discounting framework ought to be changed. It has been said that the impact which the potential loss of 15% of their tax refunds has on low-income earners and Child Tax Credit recipients should be reduced or eliminated. To address these concerns, the following options directly related to discounting itself might be considered.

##### **1. Repeal the Tax Rebate Discounting Act, and allow the Criminal Code to apply**

Section 305.1 of the Criminal Code, enacted after the Tax Rebate Discounting Act, prohibits anyone from charging loan interest of more than 60% per year. If the tax rebate discount rate of 15% were to be calculated as an annual rate on credit advanced, it would exceed 60% in any case where the refund cheque was delivered in less than about four months. However, subsection 305.1(8) of the Criminal Code states that transactions to which the Tax Rebate Discounting Act applies are not subject to the Criminal Code restriction.

The Tax Rebate Discounting Act could be repealed, and the Criminal Code could be amended to apply to discounting transactions. Most discounters would likely discontinue their discounting operations, since their potential profits would be substantially reduced. Illegal, high-rate discounting might therefore proliferate, although it has been suggested that the demand for discounting services has largely been artificially created by its legitimate availability. Cash flow difficulties for needy refund recipients might be increased, although credit on the strength of anticipated tax refunds would still be technically available, and at rates closer to the accepted consumer loan rates.

##### **2. Prohibit Discounting**

###### **a. Completely**

The Tax Rebate Discounting Act could be repealed, and the appropriate legislation could be enacted to make acquiring the right to another person's tax refund a criminal offence. This option would dramatically solve the discounting problems associated with low-income earners and Child Tax Credit recipients. It would also, however, involve the same disadvantages as Option 1, to an even greater degree, since discounting would not be technically available, at any rate of interest.



Parliament's Standing Committee on Health Welfare and Social Affairs, in its "Report on Child and Elderly Benefits", tabled in the House on April 3, 1985, recommended that steps be taken "...to outlaw tax rebate discounters."

b. Selectively

The discounting of certain types of refunds, such as Child Tax Credits or those of low-income earners, could be prohibited. Through this option, certain groups would be denied discounting services available to others. In addition to this form of discrimination, illegal high-rate discounting might become more widely available among those people who are now the most frequent users of discounting services. In addition, this option would be very difficult to administer and enforce effectively.

3. **Lower the Cost of Discounting**

a. Through an Overall Reduction

Parliament could allow the discount rate to be changed periodically by regulation. The currently permitted discount rate of 15% could be lowered to, for example, 10% or 7%. Through this option, the potential for loss of a portion of a refund would continue to exist, though the amount of loss would be considerably reduced. Many discounters, particularly smaller independent ones, would likely discontinue their legal operations, while many more taxfilers would be attracted to discounting at the lowered rate. Even with the reduced supply of services, the increased demand might result in a greater overall diversion of tax refund money to discounters.

b. Through a Graduated Reduction

A two-stage rate structure could be established, under which, for example, discounters could charge 15% of the first \$200 of any refund, but only 5% on the remainder. This option would reduce costs to taxpayers; the example given would cut the cost of the average discounted refund in half. It would also permit discounters adequate compensation for their tax return preparation costs, and other transaction costs, which do not normally vary with the amount of the refund. More legitimate discounters could likely stay in business than with the previous option, reducing the potential for illegal, high-rate discounting to develop.

c. Through a Selective Reduction

The discount rate could be reduced for selected groups only, such as Child Tax Credit claimants and low-income earners. These groups would thereby be encouraged to seek out discounters who, in response to reduced potential profits on these transactions, would reduce the availability of their services. The net result might have the same disadvantages as selective prohibition (Option 2b), as well as being similarly difficult to administer and enforce.

d. Through a Price Ceiling

A maximum discount fee of, for example, \$100 or \$150, could be established. Although those with higher refunds would thus save money, they might also be refused services by discounters, and feel constrained to seek out illegal, high-rate discounting.



#### **4. Facilitate Inexpensive Alternatives**

Some financial institutions, particularly credit unions, now offer "tax refund loan" programs, under which taxpayers may receive loans at normal consumer loan rates on the strength of their anticipated tax refunds. More institutions might implement these programs if the government were to provide them with useful information and statistical tables, and establish administrative measures to make the programs more convenient for financial institutions to operate. This option could be implemented without direct intervention in the marketplace, and may stimulate price competition among discounters. It is difficult, however, to assess the impact that it might have on the problems associated with discounting.

#### **5. Combine Options**

Some of the options described above could be implemented in combination. In particular, options which might, if carried out independently, result in a proliferation of illegal high-rate discounting could be combined with Option 4, the facilitation of inexpensive alternatives. In that way, the potential for development of a "black market" could be minimized.

#### **F. Limitations on Federal Action**

The federal government's authority to regulate discounting rates in the current manner is evidently based on its jurisdiction over criminal law. It has been suggested that the federal government would not have the constitutional authority to regulate the business practices of discounting through, for example, licensing or registration requirements, since such may encroach on the provinces' jurisdiction over property and civil rights.

Because of the historical involvement of provincial governments in the regulation of discounting, coordination of federal and provincial interests is necessary.

#### **G. Recapitulation**

Options which could alleviate any negative effects that the current tax rebate discounting framework may have do exist. Unfortunately, no one option appears to be completely free of disadvantages. Prohibiting or curtailing discounting, would solve the problems at hand, but may entail the risks of encouraging loan-sharking and increasing cash-flow difficulties for needy taxpayers. Lowering the cost of discounting would reduce its negative effects on individuals, but would increase the overall demand, and may result in a gross transfer of funds from taxpayers to discounters equalling or exceeding the current level. Facilitating cheaper alternatives through administrative and informational measures would have few negative effects, but may also have the least significant positive effect. Furthermore, some of the available options confirm the social acceptability of discounting as a business practice, while others deny it. Consultation, coordination, and cooperation are required to ensure that any action taken properly serves the interests of all Canadians.

## **APPENDIX**

### **Chart 1: Discounting Market, 1979-1984**

This graph depicts the total number of discounting transactions reported in each year from 1979 to 1984. It also shows what portion of each yearly total was conducted by H & R Block, Bentax, and independent discounters. For example, in 1983, about 150,000 refunds were discounted, with Bentax accounting for almost two-thirds of them, and H & R Block and Independents accounting for about one-sixth each.

### **Chart 2: Discounting Market, 1984, by Reported 1983 Income**

This graph depicts the income levels of the approximately 373,000 people who discounted 1983 tax returns in 1984. For example, of all those who discounted 1983 returns in 1984, about 15.6% reported an annual income of between \$2000 and \$5000.

### **Chart 3: Proportion of Population that Discounted in 1984, by Income Levels**

This graph divides the entire 1983 taxfiling population into income level categories, and shows what percentage of each category discounted their tax refunds. For example, of all female taxfilers reporting a 1983 income below \$2000, 6.74% discounted; of all male taxfilers reporting a 1983 income between \$2000 and \$5000, 5.19% discounted; of all Child Tax Credit Claimants reporting a 1983 income \$5000 and \$8000, 12.92% discounted.

### **Chart 4: Distribution of Discounted Refund Values, 1984**

This graph divides all refunds discounted in 1984 into value categories, and shows how many refunds were discounted in each category. For example, about 65,000 discounted refunds had a value of between \$300 and \$400. (The chart shows peaks at values of \$300-\$400, \$600-\$700, \$1000-\$1100, \$1300-\$1400, and \$1700-\$1800. These correspond to the values of Child Tax Credits for 1, 2, 3, 4, and 5 children respectively.)

### **Chart 5: Selected Data**

This chart shows certain relevant data for Canadians who discounted 1982 tax returns in 1983, and 1983 tax returns in 1984. It therefore covers about 97% of the refunds discounted in each year.

# DISCOUNTING MARKET, 1979-1984

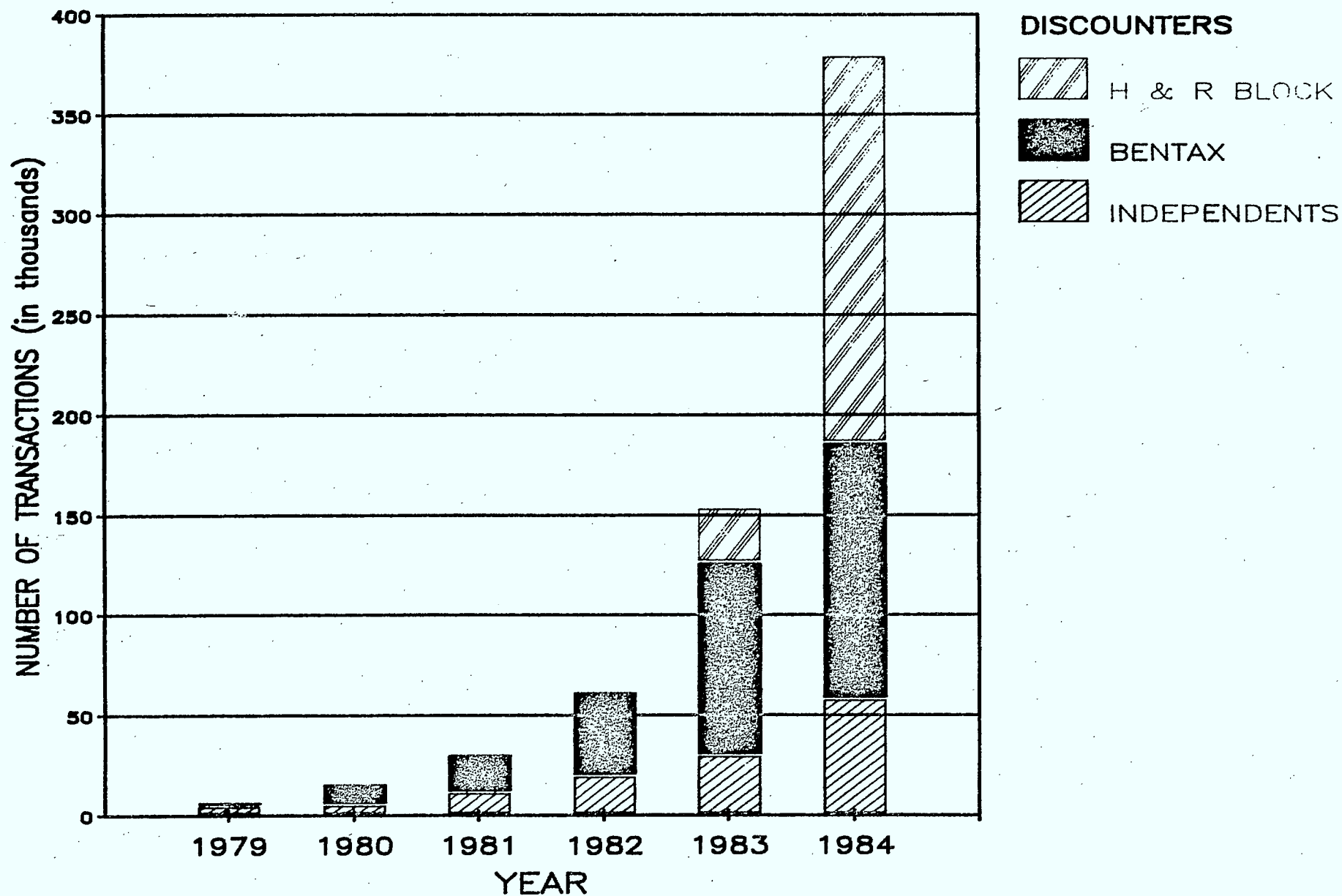
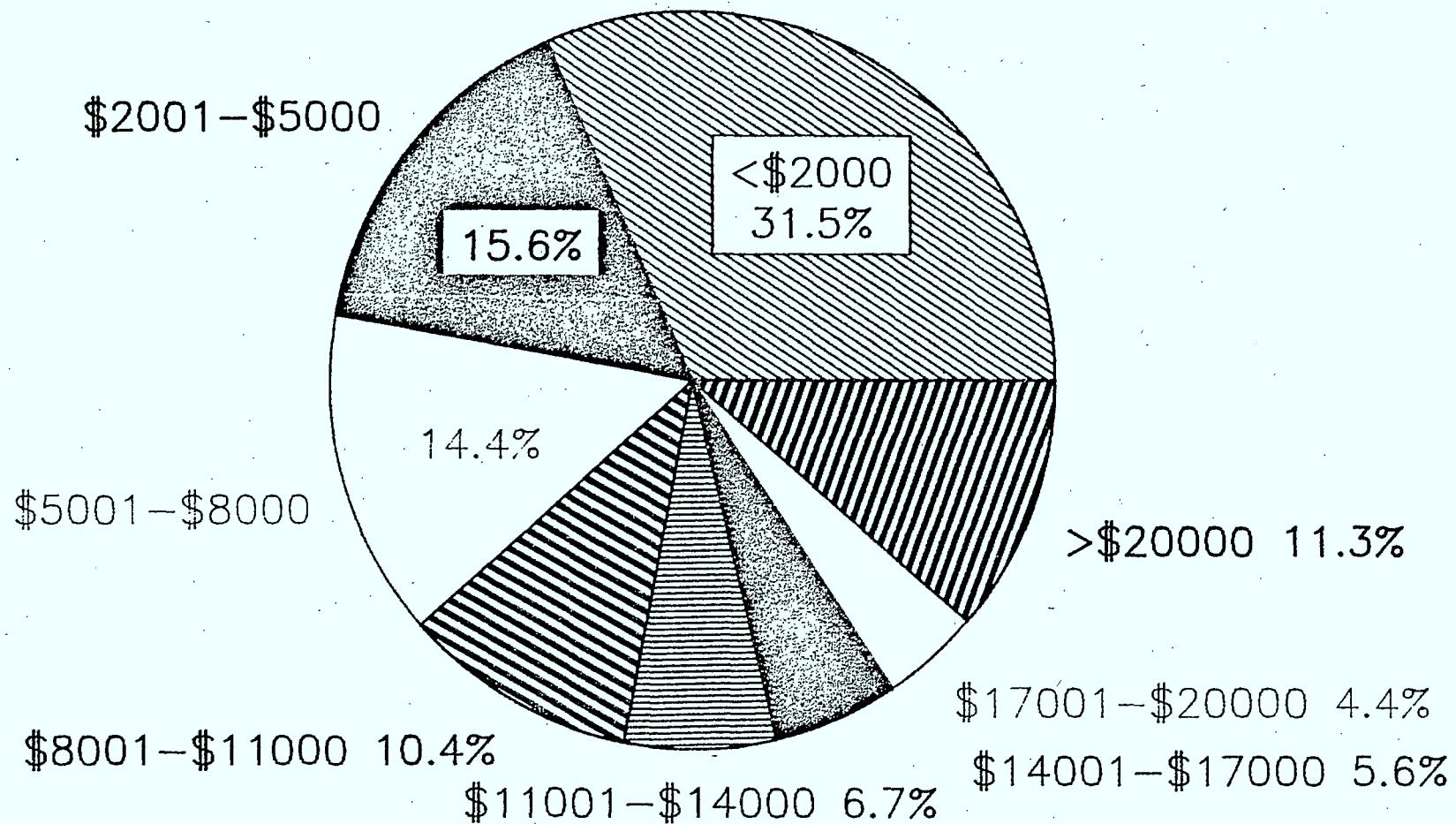


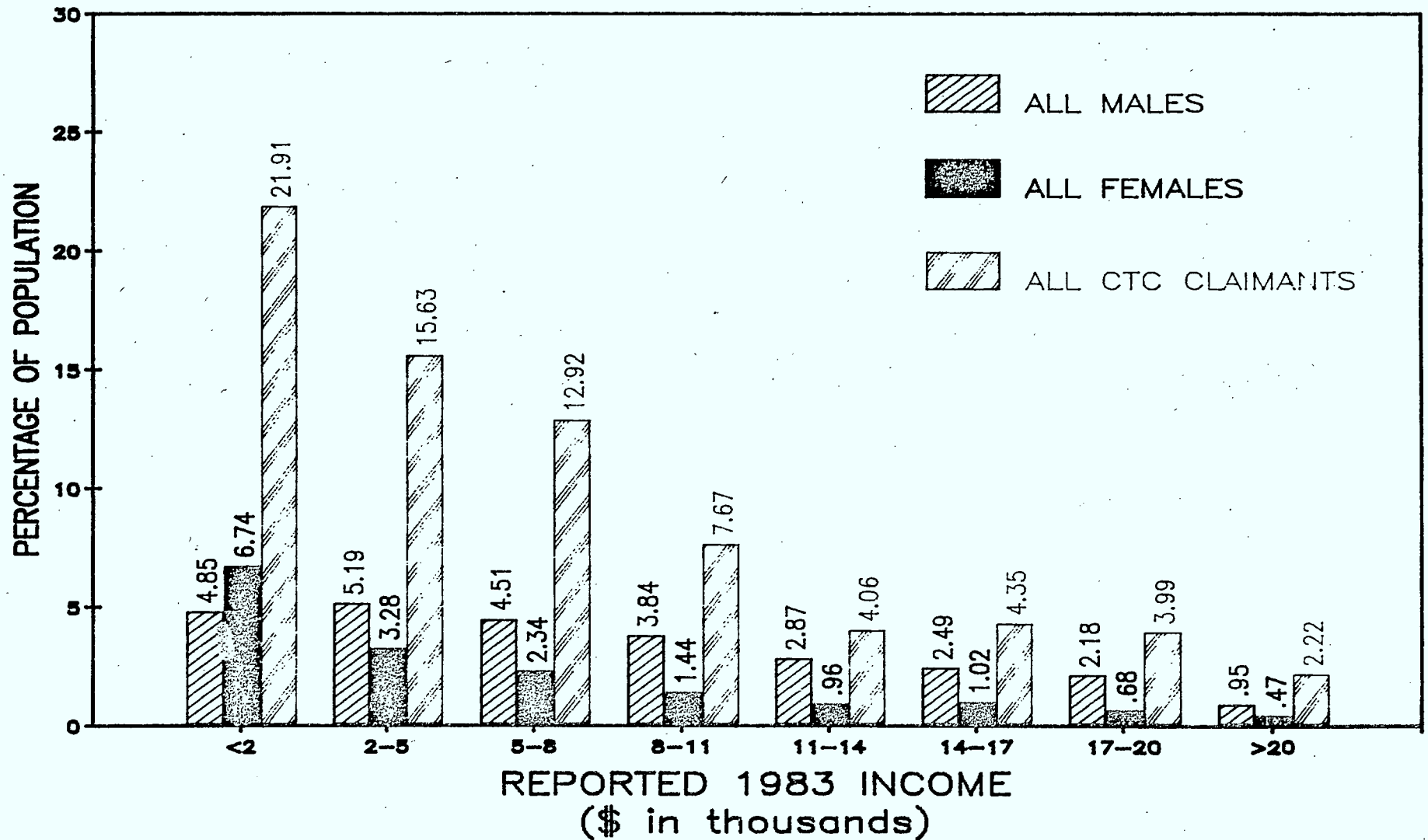
CHART 1

# DISCOUNTING MARKET, 1984, BY REPORTED 1983 INCOME

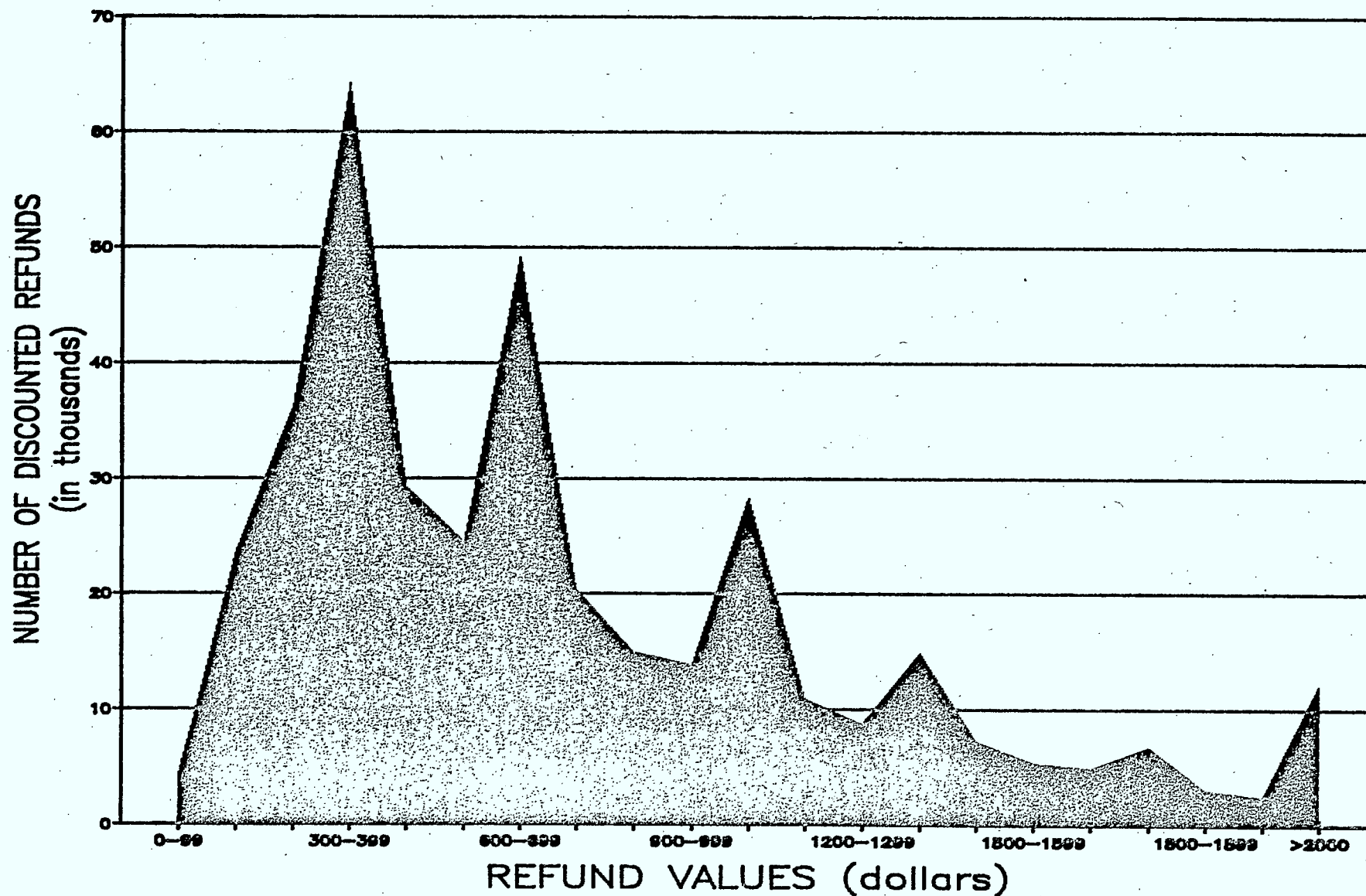




# PROPORTION OF POPULATION THAT DISCOUNTED IN 1984, BY INCOME LEVELS



# DISTRIBUTION OF DISCOUNTED REFUND VALUES, 1984



**Tax Rebate Discounting**  
**Selected Data, 1982 and 1983 Tax Years**

1. General	<u>1982</u>	<u>1983</u>
a. number of taxfilers	14,980,460	15,153,139
b. number of discountees	149,144	372,308
c. proportion of taxfilers who discounted	1%	2.5%
 2. By Sex		
a. proportion of female taxfilers who discounted	1.02%	2.6%
b. proportion of male taxfilers who discounted	.97%	2.3%
c. proportion of discounted tax returns filed by females	48.9%	50.5%
 3. By Income		
a. proportion of discountees reporting an annual income below \$8000	64.5%	61.6%
b. proportion of taxfilers reporting an annual income below \$8000, who discounted	1.95%	4.6%
c. proportion of taxfilers reporting an annual income below \$2000, who discounted	2.46%	6.4%
d. proportion of discountees reporting an annual income below \$2000	30.5%	31.5%
 4. By Sex and Income		
a. proportion of female discountees who reported an annual income below \$2000	54.1%	54.1%
b. proportion of female taxfilers reporting an annual income below \$2000, who discounted	2.59%	6.7%
c. proportion of female discountees reporting an annual income below \$8000	81.1%	82.1%
d. proportion of female taxfilers reporting an annual income below \$8000, who discounted	1.75%	4.6%

1982

1983

**5. By Child Tax Credit Status, Sex, and Family Income**

a. proportion of discountees who claimed a CTC	41.8%	43.6%
b. proportion of female discountees who claimed a CTC	83.48%	83.5%
c. proportion of female taxfilers claiming a CTC, who discounted	2.40%	6.3%
d. proportion of female discountees claiming a CTC, who reported a family income below \$2000	41.50%	39.6%
e. proportion of female taxfilers claiming a CTC and reporting a family income below \$2000, who discounted	9.35%	21.7%

**6. By Child Tax Credit Status, Sex, and Single Income**

a. number of female taxfilers claiming a CTC, and reporting no spousal income and income below \$2000	146,380	187,209
b. number of such taxfilers who discounted	8,852	45,728
c. proportion of female taxfilers claiming a CTC, and reporting no spousal income and income below \$2000, who discounted	6.05%	24.4%

**7. Median Incomes**

a. median income, all taxfilers	13,300	13,520
b. median income, all discountees	5,736	5,573
c. median income, all female taxfilers	8,709	8,884
d. median income, all female discountees	1,577	1,625



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